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FINANCIAL FOCUS



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Accountants & Advisors

Your Accounting for a New Economy

Ask the Advisors

What is a Build America Bond (BAB)?

Investors have a new way to invest in municipal bonds. The American Recovery and Reinvestment Act of 2009 authorized a subsidy for local and state governments that issue what are known as Build America Bonds (BABs) before January 1, 2011.

Unlike most municipal bonds, the interest payments you receive on a BAB are taxable on your federal income tax return. However, the federal government subsidizes 35% of those interest payments. That subsidy is made in one of two ways:

1. As a direct payment to the governmental body that issued the BAB, or
2. Via a 35% federal income tax credit on the net coupon interest to the bondholder

The governmental body that issues a BAB determines in advance which type of subsidy it prefers; so far, most governmental bodies that have issued BABs have chosen to do so using the direct payment method rather than offering the tax credit.

If you're interested in tax credit bonds, don't assume the credit automatically makes them more valuable than a fully taxable bond. Because both the bond's interest payments and the value of the tax credit will be included in your gross taxable income, the calculation depends not only on the coupon rate but also on your tax bracket. It's best to check with your financial professional to compare a BAB to both taxable and tax-free municipal bonds to determine which is the better choice for you. Any unused portion of a BAB's tax credit may be carried forward to successive years.

Before investing, make sure you know if a given BAB offers the 35% tax credit, and what it would mean given your tax bracket. Also, remember that even though the federal subsidy is designed to help lower local governments' cost of financing projects, it does not mean that the bond is guaranteed by the U.S. government, as Treasury securities are.

What is a refunded municipal bond?

In a time of falling interest rates, homeowners often try to refinance their mortgages to reduce their monthly interest payments. Issuers of municipal bonds often do something similar, issuing new bonds to pay off older debt.

The proceeds of the new bond or bonds can be used to replace a specific revenue source that was pledged to repay the interest and principal of older bonds (for example, a tax collected by the issuer or the revenues of a bond-funded project). The money received from issuing the newer bond is generally put into escrow and paid out over time as the older bond's obligations come due. Because the older bond no longer relies on its original funding source, but on the escrowed proceeds of the newer bond, the older bond is then considered a refunded bond.

Bonds that are refunded through their maturity dates are said to be "escrowed to maturity." The escrowed money is typically invested in or collateralized by U.S. Treasury securities timed to mature as the refunded bond's interest and principal payments are due. If a refunded bond's original documents include a call provision that allows the issuer to pay off the bond before its maturity date, the bond is referred to as a pre-refunded bond.

Because refunding typically occurs after interest rates have fallen, refunded bonds generally offer a higher coupon rate than equivalent newer issues, and often sell at a premium to their par value. Also, because they are backed by escrowed money that is typically invested in or collateralized by U.S. Treasury securities, they are generally considered high quality bonds, much as Treasuries are.

However, even though it may be backed by Treasuries, a refunded bond itself is not guaranteed by the full faith and credit of the U.S. Treasury. Also, municipal bonds are subject to the risks associated with any fixed income security, including interest rate risk, credit risk, and reinvestment risk. Reinvestment risk is even greater if a bond is callable, meaning it could be redeemed prior to the maturity date.